DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/21/05**	Bill No:	**AB 344**
Tax:	**Sales and Use**	Author:	**Villines**
Related Bills:	**AB 80 (Houston)** **AB 344 (Villines)** **AB 1580 (Torrico)** **SB 552 (Alquist)** **SB 631 (Dutton)**		

BILL SUMMARY

This bill would provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. The partial exemption would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter.

Summary of Amendments

The previous version of the bill only contained intent language for an exemption.

ANALYSIS

Current Law

Under current law, entities engaged in manufacturing activities that make purchases of equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for these entities.

Proposed Law

This bill would add Section 6377 to the Sales and Use Tax Law to provide an incremental[1] state sales and use tax exemption, for the following purchases by a "qualified person":

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control

[1] For calendar year beginning on January 1, 2006, 25 percent of the gross receipts or sales price would be exempted. For calendar year beginning January 2, 1007, 50 percent would be exempted, and, beginning January 1, 2008, 100 percent would be exempted.

equipment, buildings and foundations).

- Tangible personal property purchased for use in research and development.
- Tangible personal property purchased by a contractor or a subcontractor for use in a construction contract for a manufacturer for use in manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt equipment.
- Tangible personal property purchased to be used in the telecommunication industry.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing process, as described.

The bill would define a "qualified person" as any person primarily engaged in manufacturing activities, as described in the North American Industry Classification System Manual (NAICS) Sector 31-33, telecommunications activities as described in NAICS Sector 513310 to 513390, and electrical generation activities, for commercial use, that are described in NAICS Codes 22111 to 221122.

The bill would specify that the proposed exemption would not include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

As a tax levy, the bill would become effective immediately, however, the provisions would become operative on the first day of the first calendar quarter commencing more than 90 days after the bill becomes effective.

Background

For a ten-year period ending December 31, 2003, the law provided a state sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal "Standard Industrial Classification" (SIC) codes. The exemption provided a state tax portion exemption for sales and purchases of qualifying property, and the income tax credit was equal to 6% of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Certain special purpose buildings were included as "qualified property."

This sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by EDD) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was LESS than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunset at the end of 2003.

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.

- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of “prisoners’ dilemma”—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives “windfall benefits” in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. Its purpose is to reinstate the tax incentives available to manufacturers and to provide new tax incentives to telecommunications entities and power generators.
2. **Many telecommunication companies may not be currently registered with the Board.** The bill references NAICS Codes 513310 to 513390 for purposes of identifying the telecommunication entities that would be included within the proposed exemption. These entities include not only the typical telecommunications companies, such long distance carriers, cellular phone carriers, etc., but also those primarily engaged in such activities as paging services, earth stations for satellite communication carriers, resellers of satellite telecommunications, ship-to-shore broadcasting communications carriers, microwave telecommunications resellers, and others. Many of these entities may not be registered with the Board, since they are not engaged in the business of making sales of tangible goods.
3. **The bill would not reinstate the exemption for all manufacturers that qualified for the previous exemption.** This measure essentially reinstates the exemption that had previously been provided to manufacturers and broadens that exemption to

include establishments other than new businesses and telecommunications entities. However, by defining qualifying establishments by reference to specified NAICS codes, rather than SIC codes referenced in former Section 6377, some manufacturers that had qualified for the exemption prior to its repeal would not qualify for the exemption provided in this bill. For example, the logging industry is classified under the manufacturing group under the SIC code, but not the NAICS; publishers, as well, were classified under the SIC manufacturing codes, but not the NAICS. So, these two industries would not qualify for the exemption proposed in this bill. Other industries that had qualified but wouldn't under this bill because of the switch to NAICS would include those engaged in the production of industrial inorganic chemicals, miscellaneous nonmetallic mineral products, household audio and video equipment, aircraft and parts, ship and boat building and repairing, and guided missiles space vehicles and parts.

4. **Technical issues.** Subdivision (i) (page 6, lines 20 through 30) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to new manufacturers' leases of equipment. Since this bill would provide the exemption for all qualifying entities, it appears the limitation in subdivision (i) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the same tax privileges that the bill would provide to actual purchases of the same property.

   Although the Board administered the previous exemption for a 10-year period, some ambiguities in the statute caused confusion and perhaps should be addressed with the enactment of this measure. For example, the bill lacks a definition for the word "primarily" as it is used in proposed Section 6377(d)(6) – page 3, line 21. The definition for "primarily" provided in proposed Section 6377(d)(3) – page 2, lines 26-28 - only address the issue of when property is primarily used in a specific activity. It does not address the issue of whether the person claiming the exemption (i.e., the taxpayer) is primarily engaged in the required activities. This is an important issue and one that generated a lot of disputes when the Board administered Section 6377 previously. The following amendments to paragraph 6377 (c)(3) to address this issue is recommended

   > 6377(d)(3) "Primarily" as used in paragraphs (7) and (12) means tangible personal property used 50 percent or more of the time in an activity described in this section ~~subdivision (a)~~. "Primarily" as used in paragraph (6) means the qualifying person is engaged in the activities described in that paragraph 50 percent or more of the time.

Another issue relates to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on page 4, line 39, and page 5, line 16, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.

5. **Related measures.** Other measures that would provide an exemption for manufacturing activities and other related activities include:

   - AB 80 (Houston) would, beginning on the first January following the fiscal year in which the state budget deficit for the 2005-06 fiscal year is eliminated, provide a state sales and use tax exemption for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities.
   - AB 845 (Ridley-Thomas) would reinstate the manufacturer's exemption but provide a conditional sunset date depending on the growth in employment and limit the exemption based on the manufacturers' aggregate gross assets. AB 845 would also include manufacturers other than new establishments.
   - AB 1580 (Torrico) would provide a state sales and use tax exemption for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, building and electrical contracting, software production, research and development, and others.
   - SB 552 (Alquist) would provide a state and local sales and use tax exemption for purchases of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, and telecommunications, but would provide that, beginning on January 1, 2006, taxpayers would be able to accrue credits on their purchases that may be redeemed during the first fiscal year of the state budget when state revenues match expenditures.
   - SB 631 (Dutton) would reinstate the manufacturers' exemption and income tax credit, and would broaden that exemption to include purchases of equipment by electrical generators.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Current annual purchases of qualified equipment as defined in this measure are estimated as follows:

		Expenditures (in millions)		
NAICS	Sector	2006	2007	2008
31-33	Manufacturing	$19,910.0	$20,308.0	$20,714.0
513310-513390	Telecommunications	$5,633.0	$5,746.0	$5,861.0
22111-221122	Electrical Generation	$5,706.0	$5,820.0	$5,937.0
	Total	$31,249.0	$31,874.0	$32,512.0

Since this measure provides a graduated schedule for qualified expenditures, the total expenditures that qualify under this proposal are as follows:

	Expenditures (in millions)		
	2006	2007	2008
Total Expenditures	$31,249.0	$31,874.0	$32,512.0
Percent per Year	25%	50%	100%
Total Qualifying Expenditures	$7,812.3	$15,937.0	$32,512.0

Revenue Summary

The annual revenue loss from exempting qualified tangible personal property expenditures from the state sales and use tax would be as follows:

	Revenue Loss (in millions)		
	2006	2007	2008
Qualifying Expenditures	$7,812.3	$15,937.0	$32,512.0
State Loss (5.25%)	$410.1	$836.7	$1,706.9

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